

Kelloggs Rural Leadership Program 2013

What's wrong with the 50/50 Sharemilking Contract!

'The decline of the Herd Owning Sharemilker'



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Introduction

Something seems wrong with the 50/50 contract because it is in decline.

Sharemilking in New Zealand has been the main stepping stone up the Dairy Industry career pathway into farm ownership since the early 1900s. It has been a way of learning skills and at the same time building valuable equity for a dairy farmer to make that transition from stock ownership into farm ownership. Sharemilkers have been the muscle of the dairy industry working directly at the coalface to achieve long term farm ownership gratification from determined years of hard work and sacrifice. Many Farm Owners can attribute their financial success to the Sharemilking pathway. That pathway has now narrowed with declining 50/50 Sharemilking Contracts on offer. Farm workers are losing the only true opportunity to achieve dairy farm ownership. These are changing times in the dairy industry and so career pathways must also change. This report looks at the 50:50 Herd owning Sharemilker and asks why is the 50/50 Contract in decline and what is wrong with it?

The Birth of New Zealand Sharemilking

The dairy Industry in New Zealand is nearly as old as European settlement with Reverend Samuel Marsden being credited with the first introduction of dairy cattle in 1814. Cattle numbers grew and so did exporting of cheese and butter with 4.2 tonne of dairy products exported to Australia in 1859. In 1871, the first cooperative, the Otago Peninsula Cheese Factory was established near Dunedin. By 1883 the Edendale factory collected a 500

Pound bonus from the Government for the first factory to export 50 tons of cheese.

Sharemilking then began its synonymous relationship with the New Zealand Dairy Industry with the first record of it from Henley Land Co, on the Taieri Plains, in Otago. A Mr J Stevenson, manager of the company, reportedly introducing the system in 1884. It then spread in various forms throughout the popular dairying areas of the Waikato and Taranaki. The idea is considered to have come from share farming in Scotland mixed with the share cropping system in the United States to form the early contracts.

Sharemilking slowly gained prominence, as evidenced in 1921 when it was recognised as a source of employment by being included as a statistical category in census returns and then in 1937 by the Labour Government who passed the Sharemilkers agreement Act. This Act was to provide protection for the Sharemilker who didn't own the herd, known as a Variable Order Sharemilker (VOSM) from exploitation from the Farm Owner. The other type of Sharemilker is the Herd Owning Sharemilker (HOSM) or the 50;50 Sharemilker.

Dairy Farm Operating Structures

Dairy Farms in New Zealand operate under 4 main structures;

1. Owner-operator.
2. Sharemilker.
3. Contract Milker.
4. Farm Manager.

Owner Operators

Owner-operators are farmers who own and operate their own farms, or who employ a Farm Manager to operate the farm on a fixed salary. An Owner operator receives and distributes all the farm income and has overall control and responsibility in the farm operations.

Owner-operators are the largest group (66%) define in data of Dairy Farm Operating Structures¹. Greater definition of this group is needed as I suspect it would show how the owner operator has changed dramatically from mostly a traditional small herd, family operated business, to many variants of an Owner Operator such as an absentee owner, corporate owner, equity share owners, family and corporate trusts, multi-farm owners and owner operators who actually only lease the land.

Many owners may contract to a Variable Order Sharemilker but still have a large control in the farm operations.

Sharemilkers

Sharemilkers are either Variable Order Sharemilkers (VOSM) or Herd Owning Sharemilkers (HOSM), also known as 50/50 Sharemilkers. They are responsible for operating the farm on behalf of the farm owner. They do not own the land, instead they split the income and expenses of the dairy business with the land owner. This is expressed as a percentage basis such as a 50% agreement for a HOSM and any percentage less than 40% is a VOSM.

¹ (DairyNZ, LIC, 2012)

Sharemilking agreements are in effect share leasing arrangements between the Sharemilker and the Farm Owner. The Sharemilker pays rent in the form of a share of production for the use of the farm owner's capital. Both parties share the risk and rewards of low or high milk solids production and or milk solid prices.

Under the Sharemilkers Agreement Act which covers VOSM's a Sharemilker is define as; *a person who has undertaken to perform in whole or in part the work of a dairy farm otherwise than as a servant under a contract of service, and who is entitled under a Sharemilking agreement to receive a share (%) of the returns or profits derived from the dairy farming operations which are the subject matter of the agreement.*

The legal relationship between a farm owner and a Sharemilker is that of principal and independent contractor, not employer and employee therefore it is the Contractual Remedies Act and Case law that provides remedies for misrepresentation and breach of contract. This Act is the safe guard for any disagreements of HOSM.

Variable Order Sharemilkers (VOSM)

The variable-order Sharemilking agreement involves the farm owner owning the land and also retaining ownership of the livestock. Therefore VOSM's percentage of the expenses and income is normally between 19 -40%.

Since the owner's capital in the business is high they may still have a large influence on how the farm is to be managed. The amount of farm work and the responsibilities of the VOSM will vary depending on the individual agreement. Generally the VOSM's are required to provide labour, motorbikes, and are responsible for expenses related directly to consumables within the dairy shed such as power, rubber ware and detergents. Currently

13.5% of Dairy farms are operated under the VSOM system, of which almost 88% are under 30% agreements.

Herd Owning Sharemilkers (HOSM)

The HOSM or 50/50 Sharemilker differ from VOSM in that they own the livestock.

In general the Land Owner pays for any costs to associated with the land and fixed capital, such as fertiliser and buildings repairs. The HOSM manages the farm and pays for anything associated with livestock, labour and machinery. The income from the milk is split 50/50.

HOSM represent 18.2% of the industry and 55% of all Sharemilkers, Table 1.

As of the season ending 2012 the average HOSM owns 372 cows plus 93 young stock. They will produce an annual income of \$551 000, less farm Working expenses of \$315 000 to give a net profit of \$167 000. Their business will have \$1.4 million in assets, less \$552 000 in liabilities to give them an average Equity of \$859 000².

Contract Milkers

Contract Milkers are contracted to milk a herd at a set price per kilogram of milk solid produced, such as \$1.10 /kgMS. The rate is set for the whole season and includes not only the responsibility of harvesting the milk, but also all the work needed to run a successful farm.

Only a small amount of start-up capital is needed to provide cash flow to pay wages and purchase motorbikes and a few tools. Contract Milkers are categorised under Owner

² (DairyNZ, 2012)

operator's structures because of the large amount of influence the owner can still give in the management of the farm.

Farm Manager

A farm manager refers to anyone employed to manage the farm on a wage or salary. Farm Managers are categorised under Owner operators' structures because there are very few variables to their income and because of the large amount of influence the owners can still have on the operation.

Table 1 Operating Structures on NZ Dairy Farms 2011/12³

	No of Herds	Percentage of Herds	Av. Herd size	Av.Ha
Owner Operator	7764	65.8	389	139
VOSM	1600	15.4	442	151
HOSM	2434	18.8	372	130
VOSM & HOSM Sharemilkers	4034	34.2	399	138
Total Farms	11798		393	139

³ (DairyNZ, LIC, 2012)

The Sharemilking Career Path

The main career path to dairy farm ownership has been historically via Sharemilking.

Farm workers with potential gained skills to become Farm Managers, and then saved small amounts of capital to purchase tools such as motorbikes to secure contract milker or VOSM positions of 19 - 29%. They then saved more equity to purchase a tractor and secure themselves a 39% contract. If they then continued to grow equity (often in young livestock) and convince a farm owner of their worthiness they could obtain a 50/50 or HOSM contract and buy their first herd. They then may move their herd to a larger farm to increase their livestock numbers and build up equity. After a number of years they would often sell a portion of their herd to secure their own farm. This career path has been a tried and true method of achieving farm ownership for many thousands of New Zealand farmers over the last century.

Unfortunately this career path has been steadily eroded over the last 6 years by the decrease in HOSM positions available. Current Sharemilkers are staying in their positions longer than historically to achieve enough equity to purchase affordable farms. HOSM are moving slower into farm ownership. Profitable farms have grown in size and the gap between land values and cow values widens.

There are other alternative pathways to dairy farm ownership offered such as Equity Partnerships, but these are not very effective⁴ and unfortunately now the obvious proven track of Herd Owning Sharemilking is now disappearing.

The Value of Sharemilkers to the New Zealand Dairy Industry

Sharemilkers are and have been extremely valuable to the dairy industry. They currently represent 34% of all herds in an export industry with annual receipts valued at over 13.6 billion dollars.

HOSM are directly responsible for the production of over 328 million kilograms of milk solids with a forecast value this season of \$2.7 billion and they hold dairy assets valued at approximately \$3.4 billion.

However it is also the non-tangible benefits that they contribute greatly to the New Zealand dairy industry such as;

- Motivated, incentivised and highly productive work force at a low hourly rate
- An attraction for new people to enter into the industry who bring new ideas
- Provides the ability to be self-employed at relatively low risk
- The ability to build capital wealth

⁴ (Clarke, 2008)

- Sharemilkers become the future farm buyers
- Agricultural, financial and business skills are learnt moving up Sharemilking ladder
- Sharemilkers become farm and dairy company owners and leaders
- Farm owner can release capital from cows yet continue getting an income from farm
- Farm owner can step back and take a non-operational role in farm.

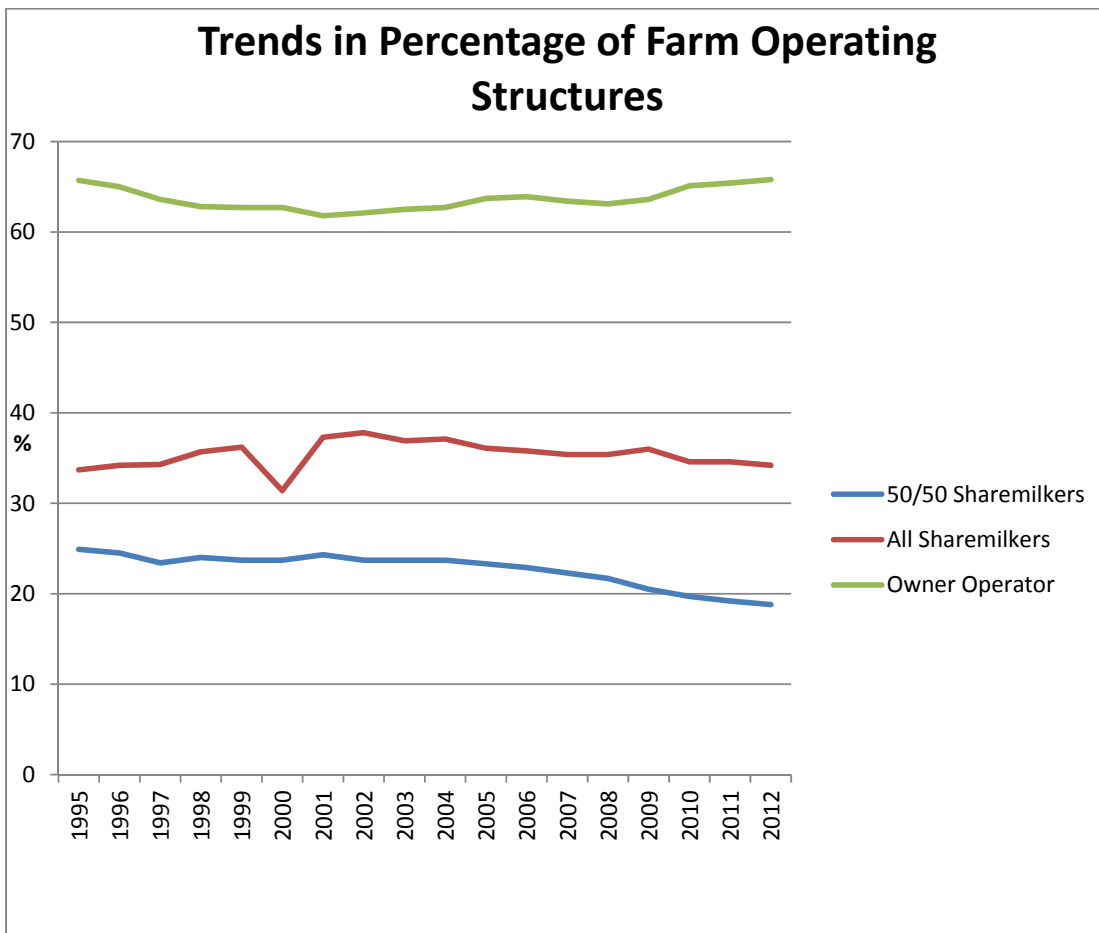
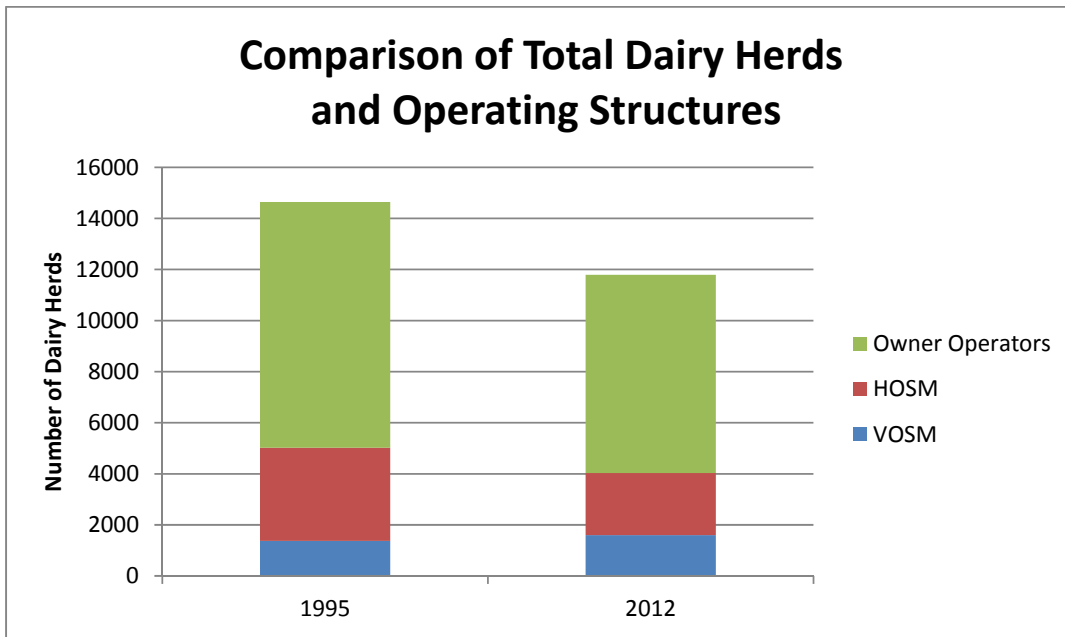
The Decline of the 50/50 Sharemilker

From 1995 till 2012 the total number of Dairy cows in New Zealand has increased by 64% from 2.8 million to 4.6 million, with herd sizes increasing by 104% from 193 cows to 393. But the total number of individual farms has decreased 19.5% from 14649 to 11798.

Over this time period the percentage of farms operated under an Owner Operated has remained the same at 66%, the percentage of all Sharemilkers has also remain the same at 34%, but what has changed is that the HOSM have decline 24% from 3642 in 1995 to 2434 in 2012 .

As a percentage of all dairy operating systems they have declined from 24.8% in 1995 to now only being 20.6% of New Zealand farms. Most of the decline has occurred since 2005 and there is no indication that it won't stop⁵.

⁵ (DairyNZ, LIC, 2012)



Why has the decline in HOSM occurred?

The originally hypothesis of this research assignment was that HOSM were in decline because the HOSM Contract was flawed from being out of date and need to be revamped. I have found that this is not the case. The contract has evolved well over time to make adjustments to changing farming systems and individual variables. The perception or reality that HOSM earn too great a share in the returns is one of the main reasons that fewer contracts are offered. This is intertwined with the changing type of farm owner, increasing value of land compared to livestock, increases in operating costs, increased debt levels and the volatility of farmer's incomes.

Reasons why HOSM are in decline are;

1. The changing Farm Owner.
2. Increasing Operating Costs
3. Increased Debt levels.
4. Volatility of dairy farm incomes.
5. Unfair distribution of Income?

1. The changing Farm Owner.

The Farm Owner holds the power in the relationship between themselves and the HOSM.

They initiate the contract and decide how long the relationship will last and what the percentage will be. But the so called Farm Owner Operator has also changed, as mentioned earlier it is a very general term which doesn't give us a true understanding of who they are and therefore what influences their decisions. Because of larger farm size and multi farm

ownership they are now far less a personal entity and more so a business entity. Therefore their decisions have become more business orientated decisions and less personal. Their influences to solve business decisions will be based around the business's strategic plans. They will be influenced by their Bankers, Accountants, Shareholders, Trustees, Directors, Equity Partners and Consultants.

As opposed to a traditional Farm Owner who took on a HOSM as a career move to step away from the daily farm operations but still retain the farm ownership. Their decisions will be about business but also will be heavily influenced by their own experience as a Sharemilker, their personal skills, family, lifestyle, retirement and succession plans. Their decisions will be influenced by their bank and accountant but also by their spouse and children.

This is not to say that a corporate farm entity won't choose to contract HOSM for all there advantages over other management systems.

2. Increasing Operating Costs

Squeezed profit margins have made it necessary for some farm owners to adopt farming systems that can provide greater profit margins and hence a move away from HOSM to farm managers and contract managers. These systems can add resilience by giving a fixed cost to labour and an opportunity of increased returns in higher milk price years.

Growth in farm operating expenses and debt servicing has been greater than the growth in dairy farm incomes⁶. Since 2008 there has been an increase in farm operating costs from around \$3.50 to \$4.50 / milk solid (average milk payout between 2007 – 2012 was \$6.69, range \$5.14 - \$7.89) mostly due to feed related cost. This has been due in part to drought conditions, but also greater acceptance of new feeds such as Palm Kernel Extract (PKE) and maize, and growing inefficiencies when farmers adapt more intense feed systems.

Thinner profit margins are exacerbated in years where there is a lower milk price payout. Add on \$1.40 for debt servicing, then take out tax, and drawings, and what is left for principal repayments and profit can be very small.

3. Increasing Debt Levels.

Increasing land values have seen banks lend and farm debt levels increase. The Reserve Bank this year has said loans by registered banks to dairy farms amount to \$32.37 billion.

In 2002 179 Dairy farms sold for an average price of \$14 512 / ha, in the period 1st July – 31st December 2012 155 Dairy farms sold for an average price of \$34 876 /ha ⁷

Debt per kilogram milk solids (kgMS) more than doubled from \$9.26 per kgMS in the 2002 season to \$20.44 per kgMS in the 2011 season. This has meant an almost doubling of debt

⁶ (DairyNZ, 2013)

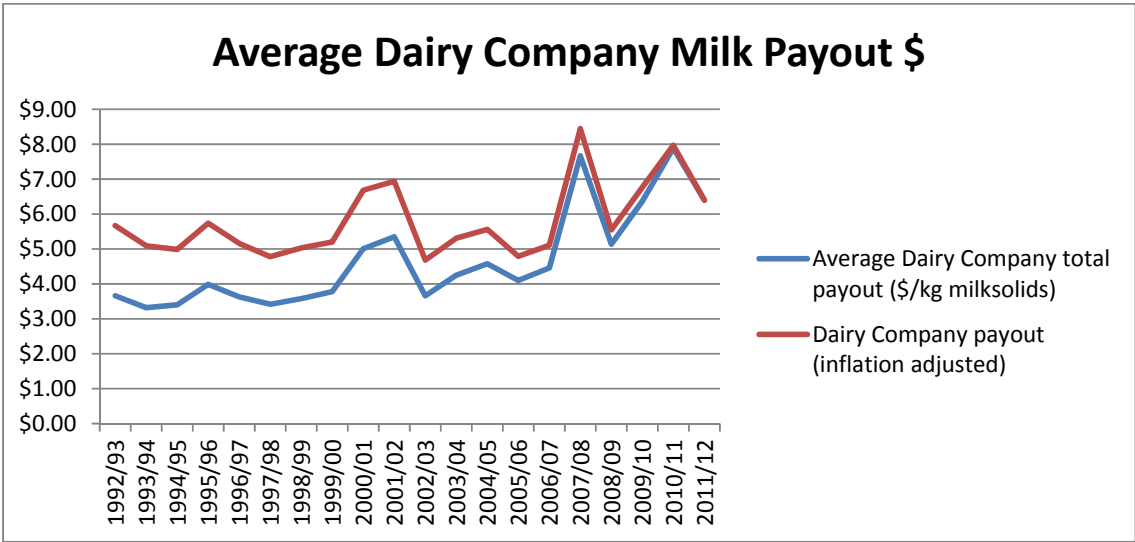
⁷ (Quotable Value, 2013)

servicing in a decade⁸. At a cost of borrowing of 7% this equates to a cost of approximately \$1.40 / kgMS which is double what it was a decade ago.

Higher debt servicing costs means savings have to be made elsewhere within the business to secure a sufficient profit margin. This has become another reason why not to engage a HOSM but for the farm owner to maintain ownership of the herd.

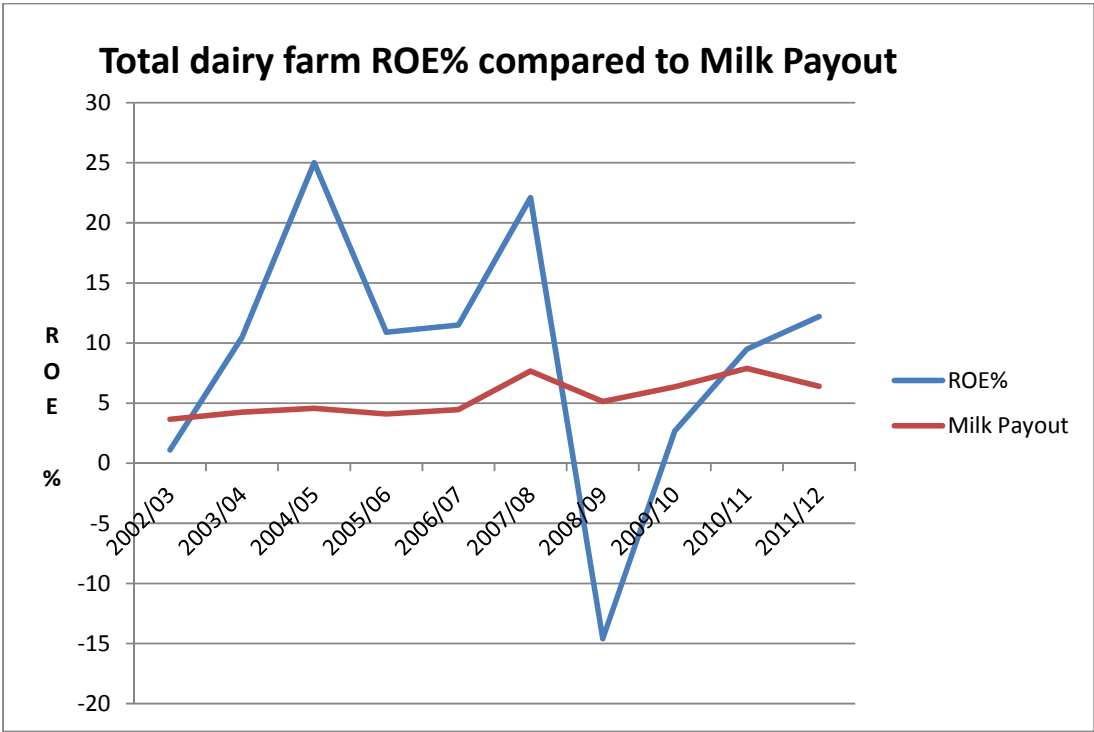
4. Volatility of Dairy Farmers income.

Over the last decade dairy farmers income has fluctuated widely (see diagram below) due to large swings in commodity milk prices. These movements have made it difficult for farmers to forecast or make consistent profits hence this has become another reason for farmers to not risk employing HOSM.



⁸ (DairyNZ, 2013)

Return on Equity (ROE) is an ideal ratio of measuring risk in the dairy industry as it is strongly linked with business growth and long-term viability.⁹



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As shown in the graph, movements in the milk payout can translate to having dramatic effects to farms Return on Equity and therefore its viability.

⁹ (Pinchet-Chateau, Shadbolt, Holmes, & Lopez-Villalobos, 2003)

¹⁰ (DairyNZ, 2012)

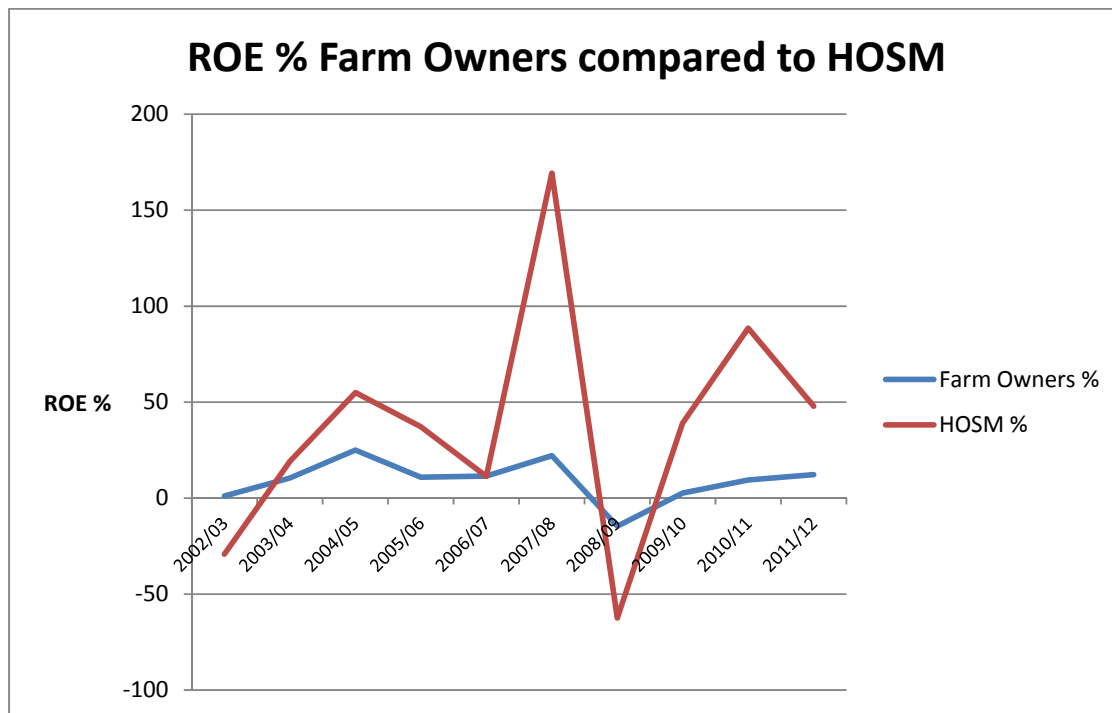
5. *Unfair distribution of Income?*

There is some justification for a Farm Owner to get concerned about how much revenue they share with a HOSM. They may have a 200ha farm valued at \$7 million, the HOSM brings a \$1 million of his asset to the farm yet they then split the revenue 50/50.

Herd values have decreased when you compare the relative cost of a cow as a percentage to land prices. From 8% in 1990 down to 4% in 2010¹¹ and the trend seems to continue. As the cost of land goes up at a greater rate in comparison to the cost of cows it would seem appropriate to adjust the returns in a comparable way. Although it is not easy to compare the relative risks of farm ownership to HOSM. Farm Ownership is a much lower risk and therefore returns are much lower but also more consistent. Whereas HOSM have their capital tied up in cows which have a much larger fluctuation in yearly values. This can be very high risk as HOSM contracts are relatively short at three years and the timing of entry and exit can cause a significant loss or gain of equity to the business. They are also far more susceptible to loss through death, disease and injury of livestock.

The graph below shows the comparison of Return on Equity percentages of Farm Owners compared to HOSM. What are most evident are the extreme swings that HOSM can experience.

¹¹ (Pangborn, 2012)



What would be the effect of no HOSM?

The HOSM will decline further but will continue to exist in a small way to offer the role that they have always done so well. If we were to consider what the New Zealand Dairy industry would be like with no HOSM would help us to understand the effect it could have on the industry as the decline continues;

Labour Resources

- Young farmers will find that it will be extremely hard for them to save enough equity while working on a farm to purchase their own farm. It will not be a realistic objective. This will have a very negative effect on the ability to attract young talented New Zealanders to dairy farming.

- Young farmers will look for alternatives, or an exit strategy. A strategy may be to invest their time, energy and money into another industry or another country such as buying a farm in Australia or South America, or invest in urban property. They will leave the industry and take their capital with them.
- There will be less human resource capabilities as a direct loss of a skilled and motivated labour force.
- Managers and staff will be needed to be sourced from overseas as New Zealand isn't producing enough graduating agricultural students to fill the demand.
- There will be a greater use of Consultants and external systems needed to keep farms on financial track.
- There will be a greater amount of work on farm done by contractors that HOSM used to perform.
- Farm work environments will need to improve to attract, develop, and retain talented and motivated people.
- Labour saving devices will be used to decrease staff working hours.
- A greater amount of Dairy Industry levy money will be spent attracting people from all levels of education.
- Industrial unrest on farms could become a reality as a disillusioned, unmotivated workforce seeks greater rewards for working long hours in difficult conditions.
- High Farm staff turnover will continue.
- There will be less self-employed people in the dairy industry.
- There will be more corporate management jobs available.

Farm Profitability

- The New Zealand Dairy Industry's competitive edge may wane.
- Farms will need to carry less debt for long term survival and resilience.
- As land prices continue to climb farms will have to become more productive and efficient to remain a worthwhile investment.
- Farm systems will continue to become more complex.
- Supply and demand of dairy products will continue to drive profitability of dairy farms and land prices.
- Profitable farms will always depend on good management.
- Less talent in the dairy industry will mean reduced returns.
- The gap between cow and land values will continue to widen.
- Innovation will lag as less talented new minds enter the industry.
- Farms will continue to get larger.
- The large variety of farm systems will make the industry more complex.

Farm Owners

- There will be fewer Farm Owners but they will own larger farms.
- Retiring farmers will decide who will milk their cows and oversee the management of their farm to provide them with a steady income.
- There will be very few new young farm owners who have worked their way up to farm ownership.
- Farm owners will decide if HOSM will continue to exist.

- Corporate farms will grow in clusters making use of close proximity to manage staff and resources.
- There will be less New Zealanders buying farms.

Government

- Government regulatory intervention will always be an unknown factor which could cause unknown changes that otherwise wouldn't occur in a free market. Such intervention could be towards overseas investment into New Zealand farms, borrowing restrictions, help to first farm buyers, labour law changes, working visas, environmental compliance. These examples could all affect farmers causing shifts in free market trends.

Conclusions

Sharemilking has been a successfully way of operating a dairy farm in New Zealand for almost a century. It has been and still does contribute significantly to the Dairy Industry and New Zealand as a whole both economically and socially.

Herd Owning Sharemilking has played an important pathway for young farmers to build up skills and equity to purchase their own farm. They have been a productive and highly motivated labour force and investor.

HOSM are in gradual decline and it seems they will continue to decline as Farm Owners choose other operating structures such as Variable Order Sharemilkers (VOSM), Farm managers, Contract Managers and Equity Partners. They are making the choice because of

monetary constraints pushing on the business from high debt levels, increasing operating costs, and fluctuating milk prices.

There is no evidence that HOSM contracts are inadequate. To the contrary they have proven to be exceptional over time with the flexibility to meet changing farm systems.

Less HOSM in the New Zealand Dairy Industry will change the labour resource. There will be less New Zealanders attracted to the Industry because of the difficulty in achieving farm ownership. Farm owners will continue to become more corporate.

The New Zealand Dairy Farmer has always been resourceful and resilient and they will continue to do so to remain leaders in the global dairy industry.

Recommendations

- HOSM are an asset to the dairy industry and therefore they are worth promoting for all the good points about them and the role they can continue to play.
- There are no alternatives comparable to HOSM for achieving farm ownership therefore a young farmer should pursue this career choice with all his energy while the opportunity still exists.
- Herd Owning Sharemilkers may need to forgo some revenue to the Farm Owner in order to retain their Sharemilking contract. Especially on large farms. The longer the contracts term the less risk for the Sharemilker.
- Revenue between a Farm Owner and HOSM could be changed so that the HOSM receives a 50/50 share of the Milk Price up to a predetermined certain amount then

after that it lowers incrementally. This way the Sharemilker has his fixed costs covered and when the payout rises the Farm Owner then also gets a higher return on his equity. It would be understood that the HOSM would still receive a higher return on equity percentage due to the nature and risk of his business.

- Lower Order Sharemilking will continue and will be a viable option for young farmers especially on large properties. The problem will still remain that it won't generate enough equity to help buy a farm.
- Consideration should be given to obtaining lease agreements as an alternative to a HOSM agreement. The lease price could be connected to the Milk Payout price so the risk is shared.
- Another alternative to Sharemilking Agreement would be a fully disclosed joint venture with predetermined return percentages.
- New Zealand Dairy Farm Owners need to lower debt levels to protect their farms security and remain profitability.
- Young people should consider studying Agricultural as they will be highly sort after to meet the services and labour resource needs of the Dairy Industry.
- Farm Owners need to develop strategies for retiring so they will have someone keen and motivated to continue the farm business profitably.
- If HOSM contracts are to survive and be promoted in the current climate the Sharemilker needs to give up some of the income in exchange for a longer term of contract, especially on high milk payout years.

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